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The Greek Crisis: Origins and Implications

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The Greek Crisis: Origins and Implications[1]

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Abstract

The conventional wisdom is that the Greek and Eurozone crises are the result of fiscal profligacy, which has justified austerity as the primary policy to exit the crisis. This interpretation of the crisis fits the case of Greece and, to a lesser extent, Portugal, but cannot explain why Ireland and Spain had to request assistance, given that prior to 2008 they had lower deficits and public debt than most Eurozone countries. The features that set the four peripheral countries apart from the rest of the Eurozone are the large current account deficits they all experienced before 2008. This observation suggests that the origins of the Eurozone crisis are to be found in external rather than fiscal imbalances. The implication is that the exclusive policy focus on reducing fiscal deficits is misguided and the four peripheral countries should be helped to reduce external deficits by recovering competitiveness.

Keywords

Greek and Eurozone crises, external imbalances, fiscal imbalances

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1. Introduction

Greece is facing an extremely severe economic crisis whose magnitude is comparable, if not worse, to the Great Depression. Between 2008 and 2013 real GDP fell by 23% and the unemployment rate reached 27.5% in 2013, almost four times the 2008 level. The roots of this economic disaster can be found in the excesses that accumulated in the years leading to the global financial crisis of 2007-08. It is therefore important to examine the events of these years both to understand the crisis's causes and to evaluate the policies that might help exit the crisis.

The conventional wisdom is that the fiscal profligacy is to blame for the Greek crisis. This perspective has three important implications: first, the Greek government is uniquely responsible for the hardship that has befallen the country because it could have behaved sensibly but chose not to; second, for Greece to exit the crisis it suffices to reduce public deficits and debts; third, the current crisis of the Eurozone could have been avoided had Greece not been allowed in the euro. This line of thinking is prevalent both in the public debate and also among politicians and policymakers. For example, during the pre-election campaign of 2013, both Chancellor Merkel and the chairman of the Social Democratic Party Sigmar Gabriel stated that Greece should not have entered the euro suggesting, implicitly or explicitly, Greece's responsibility for the Eurozone crisis.

In this paper it will be argued that this is a fundamentally flawed reading of Greece's and the Eurozone's problems. While there is no doubt that excessive fiscal deficits are an important element of the crisis, they are not the only (or even the main) culprit and reversing them, though necessary and desirable, will not by itself lead to the return of economic growth. Furthermore, the exclusive focus on fiscal imbalances has diverted attention from the necessary process of adjustment.

The method of analysis is to compare Greece with three countries that have also received help from the European Union: Ireland, Portugal and Spain. Examining Greece in the broader Eurozone context is a way of disentangling the crisis's deep underlying causes from problems which were present for Greece but were not essential in creating the overall crisis.

This comparison reveals that before 2008 fiscal conditions differed substantially between the four countries: Greece and Portugal had large fiscal deficits and public debts while Ireland and Spain were fiscally very responsible, in fact more so than Germany. This observation implies that fiscal profligacy is not the common characteristic of countries in crisis.

However, before 2008 all four countries exhibited large trade deficits and increased external indebtedness which set them apart from other Eurozone members.[2] While in Greece and Portugal it was the public sector that did most of the borrowing from abroad, in the cases of Ireland and Spain it was the private sector which was responsible for the external indebtedness. After the global financial crisis of 2007-2008 there was a sudden reduction in

[2] Several commentators have made this observation before, including Martin Wolf in the Financial Times (*Merkozy failed to save the Eurozone*, Financial Times, December 6th, 2011) and Paul Krugman in his blog at the New York Times (*European Crisis Realities*, February 25th 2012).

cross-border financial flows which created adjustment problems for all four countries, regardless of their earlier fiscal positions. Of course, countries with larger fiscal deficits, such as Greece, had less room to maneuver and experienced more severe consequences.

These observations imply that the true causes of the Eurozone crisis are the large external, rather than fiscal, imbalances. Furthermore, these imbalances affected every country of the European periphery and Greece was simply the worst affected and worst prepared country. In other words, the causes of the euro crisis were much wider than Greece and the absence of Greece from the Eurozone would not have prevented the crisis.

The implications for policy are quite stark: the affected countries, and especially Greece, need to rebalance their external account which requires that they regain competitiveness and recovering budgetary discipline, though important, does not directly help in this dimension. Up to now, however, European policy makers have focused almost exclusively on reducing fiscal deficits, a goal which is sometimes in conflict with increasing competitiveness. For the Eurozone crisis to end, this needs to change.

The next Section presents the data to support the primacy of external imbalances as the leading cause of the Eurozone crisis. Section 3 describes how these imbalances were created and why they did not attract sufficient attention until it was too late. Section 4 concludes by describing the policy implications which arise from this analysis of the crisis's origins.

2. Diagnosis of a crisis

Starting with Greece in May of 2010, five Eurozone countries have received help from the European Union (EU) and the International Monetary Fund (IMF) to finance their government budgets or to recapitalize their banks: Greece, Ireland, Portugal, Spain and Cyprus.[3] Latvia, whose currency was tied to the euro before it joined the common currency on January 1st 2014, has also received help and several other Eurozone countries, notably Italy and Slovenia, have come under pressure. Each of these countries is faced with a different combination of problems but the fact that no EU country outside the euro has faced comparable pressures suggests that there is a common Eurozone component to the crisis.[4]

This Section aims to identify the common Eurozone component by comparing the countries that ended up receiving help with those that didn't. To keep the analysis focused, attention will be directed on the eleven Eurozone countries which were part of the EU when the euro was launched, except for Luxemburg: Austria, Belgium, Germany, Greece, Finland, France, Ireland, Italy, the Netherlands, Portugal and Spain.[5] Greece, Ireland, Portugal and Spain will be referred to as the "peripheral countries" and the other Eurozone members will be referred to as "core countries".[6]

2.1 Fiscal imbalances: not so important, after all

The main cause of the Eurozone crisis is often described to be public sector profligacy. For this reason, three measures of fiscal imbalances are presented for every country under study: the average fiscal deficit during 1999-2008, the level of public debt in 2008 and the increase in public debt between 1999 and 2008, all as a proportion of GDP.

Figure 2.1 confirms the well-known fact that the Greek government ran very large deficits in the run up to the global financial crisis. The Portuguese government also ran high deficits, which were on average beyond the 3% limit set by the Stability and Growth Pact (SGP), though not quite at Greek levels.[7] However, the other two peripheral countries had a

[3] Spain has received help from the EU alone in order to recapitalize its banks.

[4] Hungary has received some help from the IMF but of much smaller magnitude (less than a tenth of the Greek bailout, for instance). Iceland, which is not in the EU, is the only country that had a crisis of similar source and magnitude without being associated with the euro.

[5] Since 2004 thirteen countries have joined the EU, six of which have also joined the euro. Of the latter group, at least three (Cyprus, Slovenia and Latvia) share many characteristics with the peripheral countries.

[6] Italy is sometimes grouped together with the peripheral countries in public discussion. In this discussion it will be included in the core group because it has not requested help from the EU and its external deficits were small.

[7] Only five countries did not break the SGP limit before 2008 (Austria, Belgium, Finland, Ireland and Spain), two of which ended up receiving bailouts. The budget deficit of Germany was above the limit every year between 2001 and 2005.

considerably better performance than, say, Germany: Spain's average deficit was less than a quarter of a percent of GDP (0.24%) while Ireland enjoyed a budget surplus over that period.

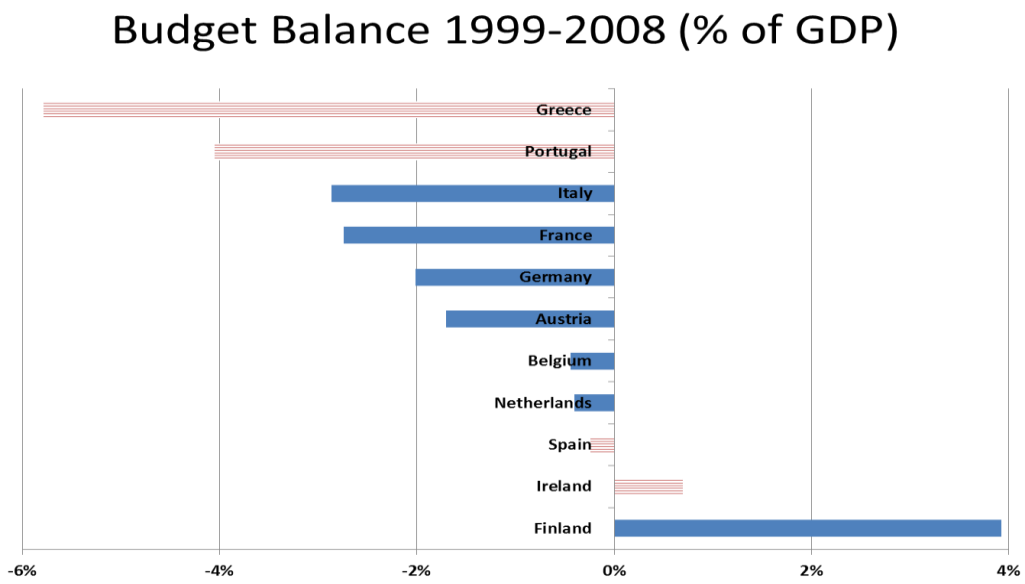

Figure 2.1 Source: Eurostat

Similarly, Figure 2.2 shows that in 2008 Greece had the highest public debt level among Eurozone countries and Portugal was the fourth most indebted, with only slightly more debt than Germany. However, Ireland and Spain had the second and third lowest levels of public debt, respectively.

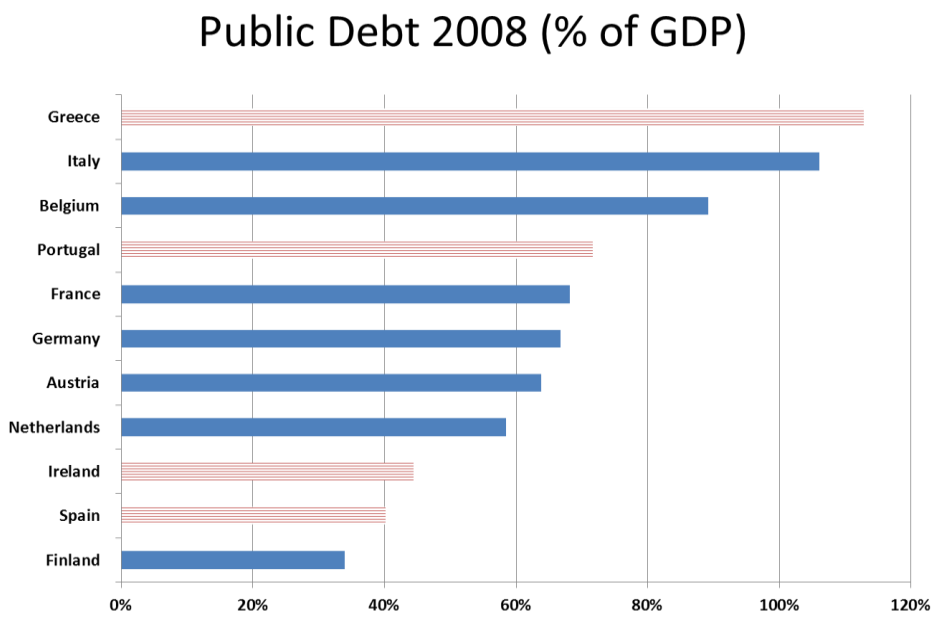

Figure 2.2 Source: Eurostat

Finally, Figure 2.3 shows that Portugal experienced the largest increase in public debt as a proportion of GDP between 1999 and 2008, followed by Greece, France and Germany. As before, Ireland and Spain were paragons of fiscal virtue reducing their public debt over that period.

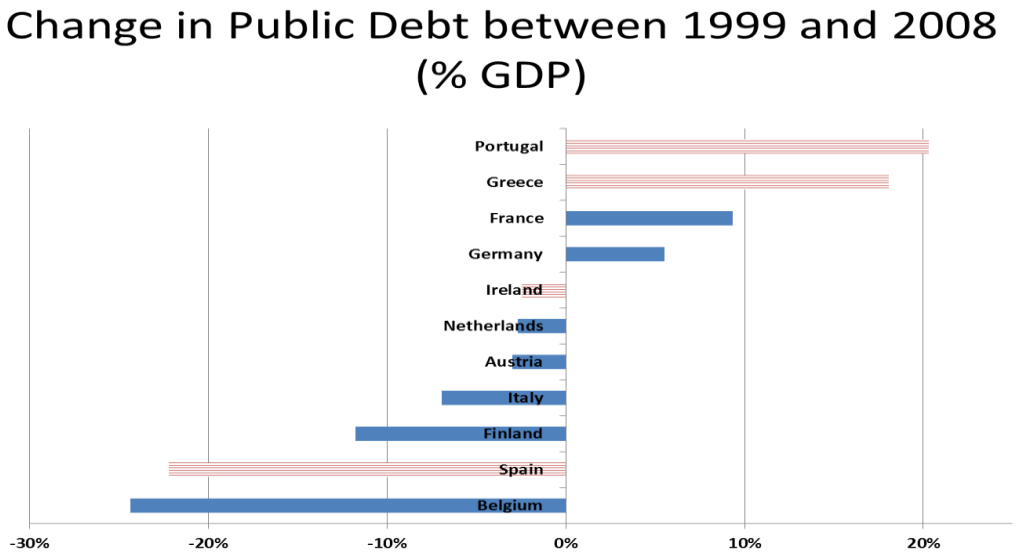

Figure 2.3 Source: Eurostat

To summarize, the conventional wisdom that fiscal profligacy was the cause of the crisis might fit the cases of Greece and Portugal but is completely incapable of interpreting why Ireland and Spain are in trouble. Indeed these two countries were much more fiscally responsible than Germany: they run very small budget deficits or even surpluses and experienced large reductions in public debt which left them with considerably less debt than Germany on the eve of the global financial crisis. Therefore, the reason why peripheral countries are in crisis and core countries are not cannot be found in their fiscal behavior.

This is not to say that fiscal policy played no role. As will be argued below, irresponsible fiscal policies exacerbated vulnerabilities and reduced the room to manoeuver after the global crisis hit. It is therefore not a coincidence that Greece had both the largest deficits and has experienced the largest decline in output among the four peripheral countries. However, the fact that the roots of the crisis do not exclusively lie on fiscal imbalances means that reducing fiscal deficits is not enough to exit the crisis.

2.2 External imbalances: the real source of trouble

The years before the global financial crisis saw the accumulation of large imbalances in several Eurozone countries but these imbalances had to do with the external account of each country as a whole rather than the public sector alone. The external account will be studied by examining data on the current account balance and the international investment position of Eurozone countries.

Before examining the data, the connection between various measures of external balance is described. The current account balance measures the difference between a country's export revenues and import costs, plus two smaller items.[8] Essentially, when a country imports more than it exports, it experiences a current account deficit and needs to borrow from abroad in order to finance the difference; when it exports more than it imports, it lends to foreign countries. Importantly, the domestic borrower (or lender) might be either the private or the public sector. A country's international investment position measures the sum of all foreign assets owned by domestic citizens minus the domestic assets held by foreigners and it reflects the accumulation of past current account deficits or surpluses: a current account deficit reduces a country's international investment position while a surplus increases it.

Turning to the data, the average current account balance of Eurozone countries between 1999 and 2008 is depicted in Figure 2.4. In contrast to the Figure on budget deficits, the peripheral countries had the largest current account deficits among Eurozone countries.

[8] Net income and net transfers are the other components of the current account.

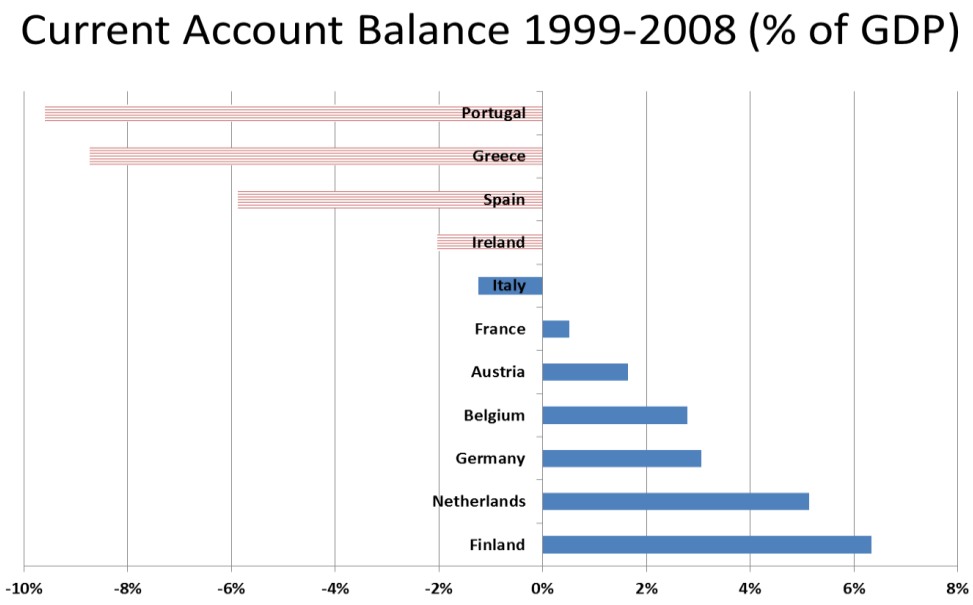

Figure 2.4 Source: IMF

Figure 2.5 ranks countries according to the change in their current account balance between the 1990s and the 2000s, so that Portugal had the largest deterioration and Finland the largest improvement in their respective current accounts. This Figure corroborates the previous evidence by showing that peripheral countries experienced the largest deterioration in their current account. An important feature, which will be further analyzed in the following Section, is that no country had a large current account deficit in the earlier period (Portugal's deficit was largest at just 2.5% of GDP) while every peripheral country experienced a significant deterioration after the euro was introduced.

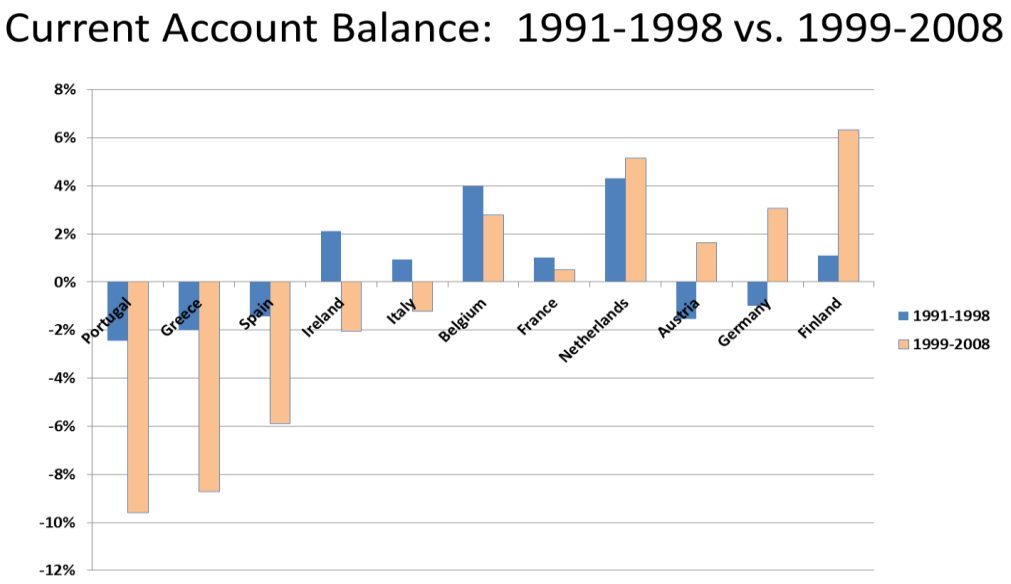

Figure 2.5 Source: IMF

Finally, Figure 2.6 shows that the peripheral countries had very negative international investment positions, with net foreign debts exceeding 60% of GDP in every peripheral country.

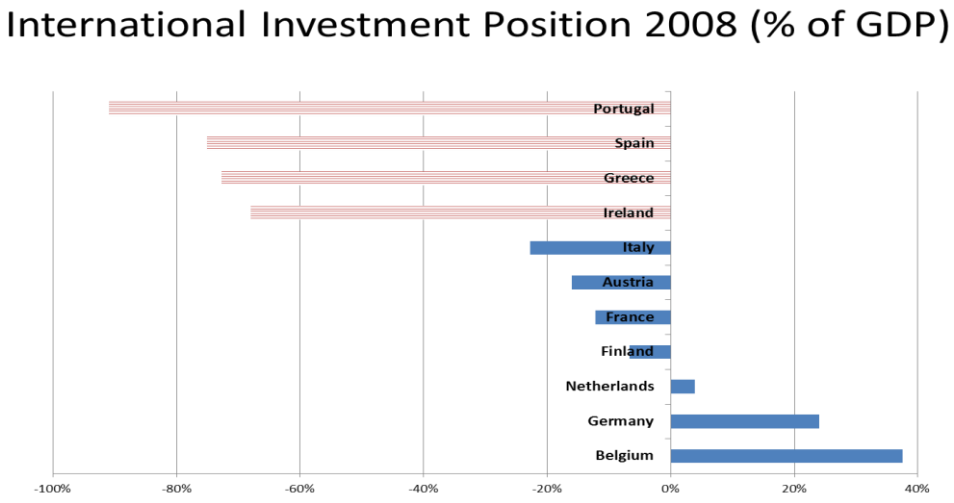

Figure 2.6 Source: IMF

To summarize, the four Eurozone members with the largest current account deficits, the greatest deterioration of their current account since the 1990s and the highest levels of external indebtedness ended up requesting help from their EU partners. However, only two of these countries (Greece and Portugal) exhibited fiscal excesses prior to 2008. Therefore,

the best indicator for whether a Eurozone country entered a crisis after 2008 was the presence of external imbalances while fiscal imbalances were of secondary importance. The main conclusion is that in order to understand the Eurozone crisis and, especially, to assess what needs to be done, it is external imbalances that need to be studied.

3. External imbalances and the euro

The introduction of the euro gave great impetus to the financial integration of the Eurozone. Capital flows increased dramatically for all euro countries and lending conditions converged across the Eurozone. While this development appeared initially to be benign and to facilitate the convergence of incomes across Europe, it ended up creating vulnerabilities which were exposed when the global financial crisis reached Europe.

3.1 Financial integration and the euro

The increase in the Eurozone's financial integration becomes evident when examining the two most direct measures of financial integration, the magnitude of cross-border capital flows and the differentials in credit conditions across the Eurozone.

The amount of capital flowing from one Eurozone country to another, either to be directly invested or lent, reached 40% of Eurozone GDP in 2007, more than double the proportion of 1999.[9] While capital flows also increased globally in that period, the within-Eurozone increase was much larger. It should be noted that flows increased in every direction, e.g. more capital flowed both from Germany to France and from France to Germany. The important point is that cross-border capital flows became much easier within the Eurozone after the euro's introduction.

At the same time, credit conditions converged across the Eurozone. A good indicator of a country's overall credit conditions is the long-term interest rate at which its government borrows since the rates of private sector borrowers are typically based on sovereign rates plus some extra risk premium. Following the introduction of the euro, sovereign interest rates converged almost completely within the Eurozone, as can be seen in Figure 3.1: between 2001 and 2008 every Eurozone country could borrow essentially at German rates and spreads never exceeded half a percentage point. This is a remarkable development given that in the early 90s German interest rates were 16 percentage points lower than Greek rates, 6 percentage points lower than Italian rates and even France had to pay a full percentage point more than Germany.[10]

[9] The data is from the IMF. A detailed description can be found in Lane (2013).

[10] Regarding private sector loans, the standard deviation of the interest rates across Eurozone countries declined from around 4 in 1990 to less than 1 in 1999, according to the European Commission.

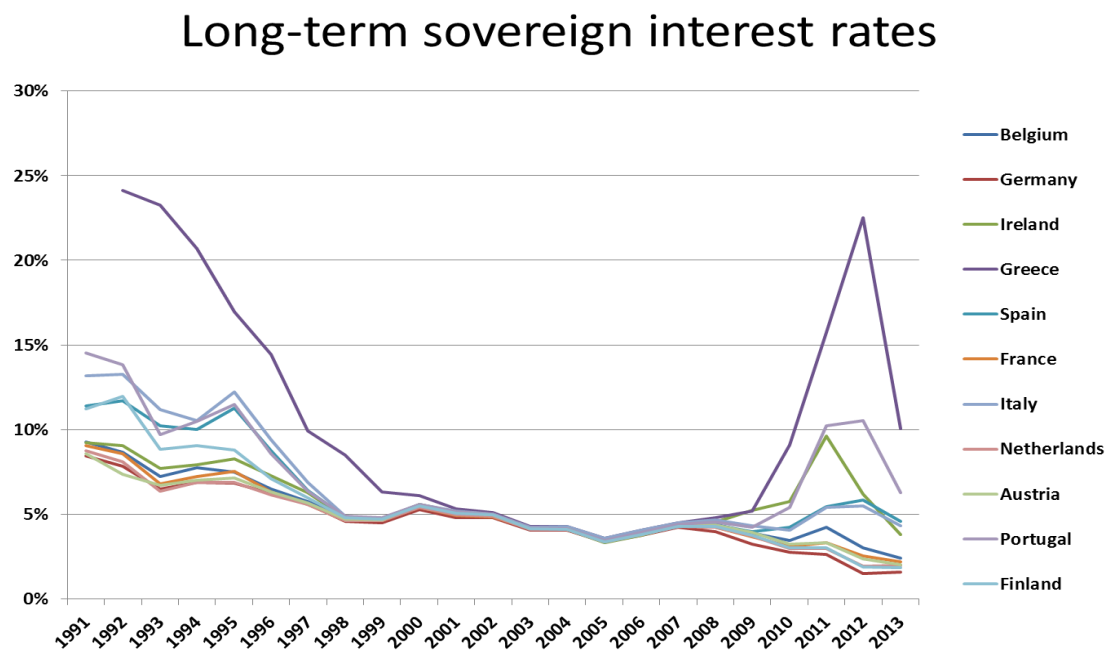

Figure 3.1 Source: Eurostat

The introduction of the euro deepened financial integration by eliminating exchange rate risk and leading to the harmonization of financial regulations across the Eurozone.[11] It is important to note that this development was judged to be a sign of the euro's success, since financial deepening was one of the main goals of the euro. For example, the European Commission stated some of the euro's benefits as follows:

> A single financial market allows individual citizens and companies to invest throughout the euro area to obtain the best return on their savings. It creates opportunities to borrow from across the euro area, seeking out the lowest cost for their loan. Investors can also spread risks more widely. (http://ec.europa.eu/economy_finance/euro/why/single_market/index_en.htm)

3.2 The euro, capital flows and the periphery

The introduction of the euro affected peripheral and core countries differently. An important outcome of the euro was a significant flow of capital from the core towards the periphery.

[11] See Kalemli-Ozcan, Papaioannou and Peydro (2010) for an extensive analysis.

Figure 3.2 plots the current account balance for the 11 Eurozone countries as a whole (line) and also separately for the peripheral (red area) and core countries (green area) as a proportion of Eurozone GDP.[12]

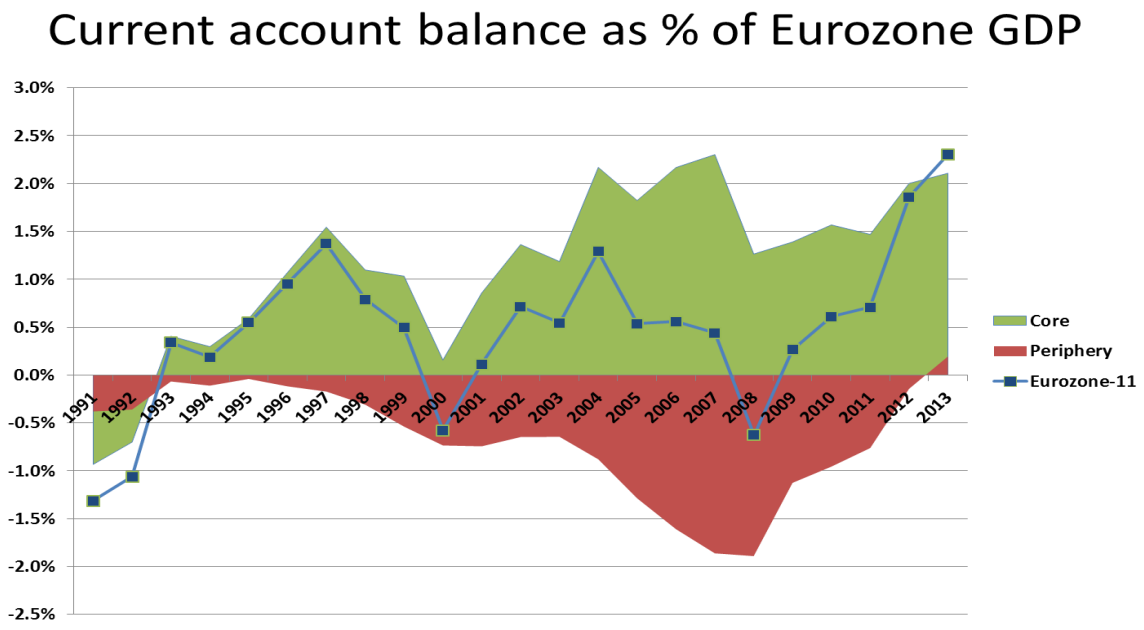

Figure 3.2 Source: IMF

When the euro was introduced in 1999, the current account of the Eurozone had a small surplus which remained relatively stable during most of the following years. However, the composition of the current account changed considerably. Peripheral countries started with a very small deficit which increased substantially over the years, reaching 1.75% of Eurozone GDP by 2008 (at that time the peripheral countries constituted about one sixth of Eurozone GDP). Concurrently the current account surplus of the core countries increased by almost the same amount, exactly offsetting the peripherals' increased deficit. Therefore, after the euro was introduced core countries experienced capital outflows (their current account improved) while peripheral countries experienced capital inflows (their current account deteriorated).

3.3 Expectations of convergence

The dramatic increase of capital flows to the periphery did not initially appear to be a cause for concern because, thanks to the euro, peripheral countries were expected to converge

[12] Since 2008, another six countries have joined the Eurozone. Figure 3.1 shows the current account of the 11 members under study for the whole period.

towards the core in terms of economic performance. Two main reasons were behind this expectation.

First, the elimination of exchange rate risk benefited peripheral countries disproportionally since their currencies had experienced deeper and more frequent devaluations in the past. This led to a large decline in the interest rates at which peripheral governments (and by extension the private sector in these countries) could borrow as is evident in Figure 3.1.

Second, the euro was expected to enhance growth prospects in peripheral countries, making them a profitable destination for foreign investment. In 1998 the per capita income of peripheral countries was only 61% of the level of core countries, suggesting that there was ample potential for catch-up growth. Joining the euro eliminated devaluation as a macroeconomic strategy and left productivity-enhancing reforms as the only way to gain competitiveness. Such reforms, which were politically costly and had been avoided in the past, were expected to raise living standards to core country levels.

This idea was described with great clarity by Lucas Papademos who was the governor of the Bank of Greece at the time of Greece's accession to the euro:

> After entry in the euro area, the Bank of Greece will be implementing the single monetary policy decided by the Governing Council of the European Central Bank and it will certainly be impossible to improve the economy's international competitiveness by changing the exchange rate of our new currency, the euro. The objectives of higher employment and output growth will therefore have to be pursued through structural reforms and fiscal measures aimed at enhancing international competitiveness by increasing productivity, improving the quality of Greek goods and services and securing price stability.[13]

The economic developments of 1999-2008 seemed to confirm the expectations of convergence. Real GDP growth at peripheral countries averaged 3.6% per year, as opposed to 2.2% for the core, and per capita income reached 75% of core countries by 2008.

Furthermore, the sources of growth appeared to be sound. Investment grew fast in Greece, Ireland and Spain and its share of output increased by more than 3 percentage points in all three countries (see Table 3.1). The periphery's current account deficits, therefore, seemed to reflect the reallocation of capital across the Eurozone in a way that made everyone better off: peripheral borrowers gained greater access to capital and core lenders received a higher rate of return than they could by investing at home. This development was judged to be a sign of the euro's success because economic convergence was one of the main goals of the euro.

[13] Lucas Papademos, *Opening address for Greece's Economic Performance and Prospects*, Athens, Greece, Bank of Greece and the Brookings Institution, 2001, xxxvii.

Investment (% GDP)	Greece	Ireland	Portugal	Spain	Core countries
1995-2001	20.2%	21.0%	25.9%	23.5%	20.6%
2002-2008	23.3%	24.3%	23.2%	28.7%	20.1%
Change in total investment	3.1%	3.3%	-2.7%	5.2%	-0.5%
Change in housing investment	0.6%	4.2%	-1.9%	3.6%	-0.1%
Change in investment other than housing	2.5%	-0.8%	-0.8%	1.6%	-0.4%

Table 3.1 *Source: Eurostat*

There was some concern about the magnitude of external indebtedness and, in particular, the decline of savings but fast economic growth made repayment look manageable. The markets certainly shared this optimistic assessment as they were willing to lend at very low rates all the way up to the global financial crisis. The evidence of convergence and the wide-spread euphoria of the era meant that the optimistic view was dominant.[14]

3.4 Hidden vulnerabilities

In retrospect, of course, it is clear that the external imbalances that were building up in the years before the global financial crisis were less benign. On the one hand, the large capital inflows led to an economic boom and large increases in wages and prices in the periphery. On the other, the productivity increases that would facilitate the repayment of foreign debts did not materialize, at least not at the expected magnitude. This resulted in a loss of competitiveness which made peripheral countries ever more dependent on the continuation of capital inflows to sustain growth and ever more vulnerable to their reduction.

This development has several sources. The easy availability of funds was not used optimally by the recipient countries. The allocation of investment consisted mostly of housing construction: as can be seen in Table 3.1, investment outside the housing sector actually fell in Ireland and Portugal as a proportion of GDP while it increased relatively modestly in Spain and more substantially in Greece. While housing investment might benefit the countries where it takes place (and an argument can be made that there was a lot of wasteful overbuilding in the bubbles of Ireland and Spain) it does not improve an economy's ability to export. Therefore, housing investment was financed with foreign loans but could not by itself help repay these loans. Incidentally, this was much less of a problem for Greece than for the other countries.

[14] Many academics were also optimistic including Olivier Blanchard, who is currently the IMF's chief economist. See *Current account deficits in the euro area*, Brookings Papers on Economic Activity, 2002 (vol. 2), 147-209.

External indebtedness was in some cases compounded by bad public policy. The large drop in interest rates reduced the payoff to saving and led to a decline of private saving rates in all peripheral countries (see Table 3.2). Whether this translated into a decline in national savings depended on the policy response, which varied across countries. The national savings of Ireland and Spain fell only marginally because their governments increased public savings by reducing budget deficits. The governments of Greece and Portugal, however, took advantage of the easy credit conditions to increase their borrowing, causing an even larger decline in national savings. This further increased the need to borrow from abroad, expanding the current account deficit and exacerbating the vulnerability to a reversal of flows.

	Time period	Greece	Ireland	Portugal	Spain	Core countries
Private savings	1995-2001	16.5%	18.3%	19.4%	21.0%	22.1%
(% of GDP)	2002-2008	13.4%	17.8%	15.7%	17.4%	22.1%
	Difference	-3.1%	-0.5%	-3.7%	-3.6%	0.0%
Public savings	1995-2001	-1.9%	4.0%	0.0%	1.1%	1.2%
(% of GDP)	2002-2008	-3.3%	3.6%	-1.7%	4.5%	1.8%
	Difference	-1.4%	-0.4%	-1.6%	3.4%	0.6%
National savings	1995-2001	14.6%	22.4%	19.4%	22.1%	23.3%
(% of GDP)	2002-2008	10.1%	21.4%	14.1%	21.9%	23.9%
	Difference	-4.5%	-0.9%	-5.3%	-0.2%	0.6%

Table 3.2 *Source: Eurostat*

Furthermore, there is significant evidence that institutional quality in peripheral countries actually deteriorated after joining the euro, rather than improve which is what policymakers (such as Papademos) were expecting. This can be seen in the Worldwide Governance Index (WGI), a set of indicators created by the World Bank to measure the quality of governance by surveying private, public and NGO experts on governance. Table 3.3 shows the values of the index for "government effectiveness", "control of corruption" and "regulatory quality" for each peripheral country and the average of core countries for the time periods before the euro (1996-98) and before the global crisis (2006-08).[15]

[15] WGI also collects information on "voice and accountability", "political stability" and "rule of law" which, however, do not vary much across developed countries and are therefore not reported here. The index of government effectiveness "reflects perceptions of… the quality of the civil service and the degree of its independence from political pressure, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies." The index of corruption "reflects perceptions of the extent to which public power is exercised for private gain… as well as 'capture' of the state by elites and private interests." The index of regulatory quality "reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development". http://info.worldbank.org/governance/wgi/index.aspx

	Time period	Greece	Ireland	Portugal	Spain	Core countries
Government effectiveness	1996-1998	0.79	1.74	1.14	1.64	1.70
	2006-2008	0.61	1.55	0.95	0.94	1.51
	Difference	-0.17	-0.19	-0.19	-0.71	-0.19
Control of corruption	1996-1998	0.70	1.69	1.43	1.21	1.68
	2006-2008	0.23	1.74	0.97	1.07	1.63
	Difference	-0.46	0.05	-0.37	-0.18	-0.07
Regulatory quality	1996-1998	0.65	1.63	1.22	1.18	1.29
	2006-2008	0.87	1.87	1.07	1.20	1.45
	Difference	0.22	0.24	-0.15	0.02	0.16

Table 3.3 *Source: World Bank*

Two features are notable in this Table. With the exception of Ireland, peripheral countries have much lower scores than the core country average in all three categories. Furthermore, the index for government effectiveness and control of corruption deteriorated markedly for peripheral countries between the late 90s and the late 00s, again with the exception of Ireland. This deterioration occurred after euro accession when governance was supposed to be improving. The category of regulatory quality is the only one where performance actually improved for Greece and Spain.

This evidence presented in Fernandez-Villaverde, Garicano and Santos (2013) corroborates this impression. They examine case studies in each of the peripheral countries which illustrate the decline in government effectiveness and increase in corruption during the boom years. Overall, it seems that the ease with which the private and public sectors could borrow created a laxer economic and political environment which discouraged reform.

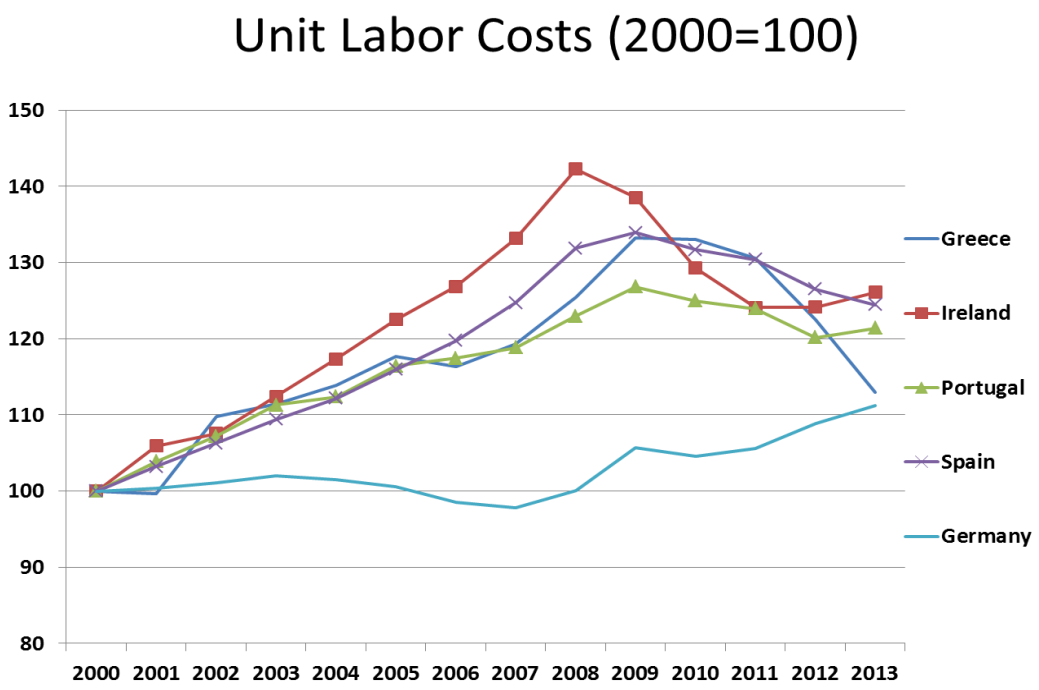

Figure 3.3 Source: Eurostat

In sum, during the euro's first decade the Eurozone's peripheral economies experienced large inflows of capital from the core which fueled an economic boom but also led to the build-up of severe imbalances. Prices and wages increased substantially which were not accompanied by similar increases in productivity, leading to a gradual loss of competitiveness. The most direct way to gauge the evolution of competitiveness is to examine a country's unit labor costs, which measures the productivity-adjusted wage. Figure 3.3 shows that between 2000 and 2008 unit labor costs of peripheral countries increased by 30% more than in Germany, on average.

4. The aftermath of the global financial crisis: developments and policy

After the global financial crisis investor sentiment changed radically from euphoric optimism to an extreme aversion for all types of risk. The growth prospects of peripheral countries were downgraded, along with the rest of the world's, and the vulnerabilities of the Eurozone periphery attracted more attention than before. As a result, the willingness of foreign investors to fund peripheral countries declined dramatically, sparking the Eurozone crisis.

The reduction of international capital flows towards the European periphery created pressure on the peripheral countries to close their external deficits and balance their trade. For this to happen, economic activity had to reallocate towards the production of tradable goods and services to expand exports to foreign markets and displace imports in the domestic market. For this to happen, however, competitiveness had to first be restored.

In the past, this could be achieved via currency devaluation which reduces domestic wages and prices vis-à-vis foreign ones. However, by joining the euro this option had been forfeited – and indeed it was exactly the absence of that option which encouraged capital inflows in the first place. Therefore, competitiveness had to be regained through reductions in nominal wages and prices and through improvements in productivity, a process called "internal devaluation". This process is slow and can be especially painful for countries whose economies are characterized by extensive rigidities as was the case in the Eurozone periphery. To a large extent, the economic problems currently facing the peripheral countries are a reflection of that difficulty.

Low growth prospects and severe economic dislocation suffice to generate budget problems even for governments that had not been particularly spendthrift. Combining them with a large pre-existing debt level (Greece, Portugal) or the need to bail out private banks (Ireland, Spain) was enough to create a full-blown confidence crisis about governments' ability to honor their debts. As a result of the crisis of confidence, peripheral countries lost access to financial markets and resorted to borrowing from their EU partners in order to fund their budgets (or, in the case of Spain, to recapitalize banks).

4.1 The evolution of fiscal and external deficits since 2008

Support programs from the EU and, in the cases of Greece, Ireland and Portugal, the IMF and the European Central Bank (the so-called "troika") did not come for free: the recipient countries had to fulfil ambitious programs of budgetary consolidation and economic reform. However, the emphasis of these programs was primarily on reducing budget deficits.

The programs' outcomes reflected the priorities set by the designers. Figure 4.1 shows that between 2009 (the last pre-bailout year) and 2013 peripheral countries on average improved their overall budget balance by 6.5% and their primary balance (i.e. before interest payments) by more than 8%.[16] This is remarkable, especially since the improvement

[16] These numbers do not include one-off expenses for the recapitalization of banks.

occurred in a period of extremely severe recessions which hindered deficit reduction by reducing tax revenues and increasing the demand for social spending.

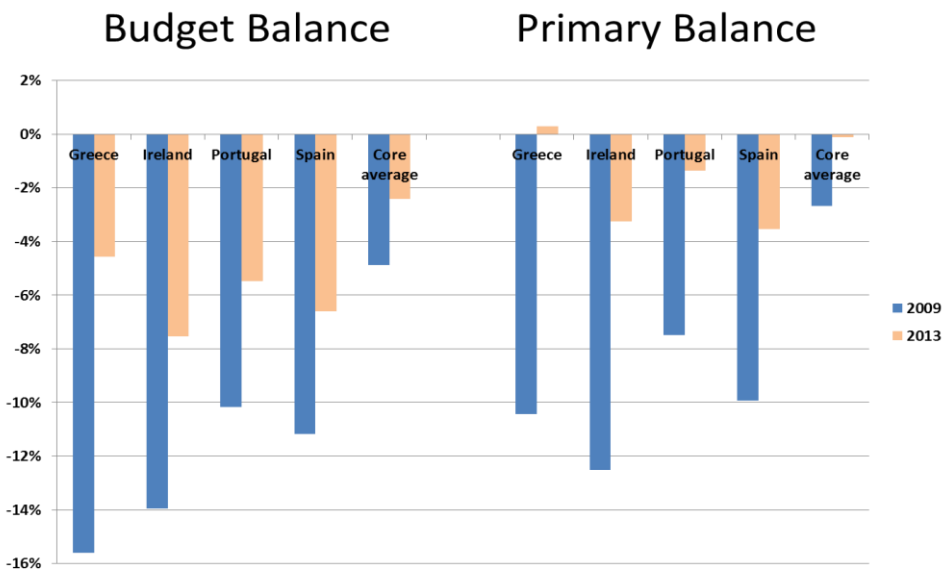

Figure 4.1 Source: IMF

A substantial correction also took place on the external account. Between 2008 and 2013 the trade balance of all peripheral countries has improved between 8% and 13% of GDP. However, the composition of the improvement varied dramatically across countries with great implications for economic activity. As can be seen in Figure 4.2, Greece's improvement is driven exclusively by a reduction in imports, while exports actually fell over that period (a drop in imports appears with a positive sign because it improves the trade balance).[17] The other three countries exhibited a more balanced adjustment in their trade.

The Greek pattern of adjustment is problematic for at least two reasons. First, it means that the necessary economic adjustment towards the production of tradable commodities is not taking place and therefore the recession is more severe than it would otherwise be. Second, the improvement in the trade balance is unlikely to prove sustainable because the decline in imports will be reversed when the economy recovers – or it might hinder the recovery altogether.

[17] See Doxiadis (2011) for a wide-ranging discussion of Greece's difficulties in this regard and Arkolakis, Doxiadis and Galenianos (2014) for an analysis of the pattern of adjustment.

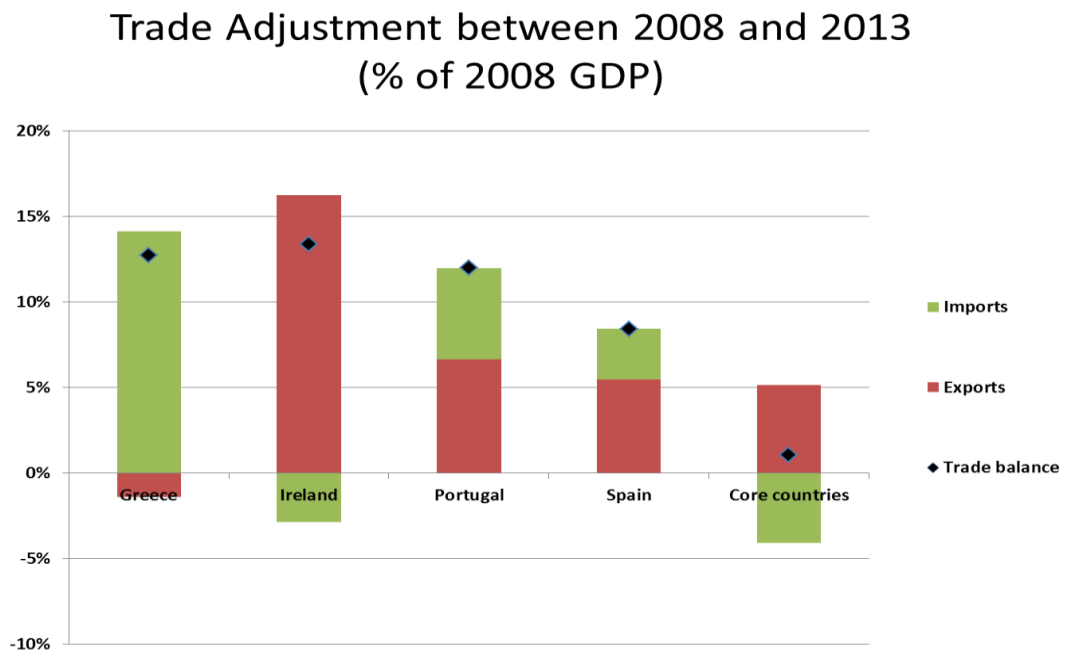

Figure 4.2 Source: Eurostat

It is therefore clear that, progress on fiscal imbalances notwithstanding, Greece has a long way to go in order to fully adjust to the new economic environment. Therefore, the focus on fiscal imbalances at the expense of external imbalances was a mistake.[18]

4.2 Challenges for policy regarding Greece

This paper's conclusion is that the most important task facing the Eurozone periphery is the recovery of competitiveness and the rebalancing of the current account. Four sets of policy implications are sketched regarding Greece, where this process has the longest to go, but several also apply to other peripheral countries.

First, labor markets should be flexible so that labor can reallocate to export-intensive sectors. Labor markets were significantly liberalized in 2011 leading to a competitiveness-improving drop in wages. The social cost of the ensuing dislocation, however, was magnified by the simultaneous reduction in social expenditures, which was mandated in the name of fiscal adjustment. Combining such reforms with increased support for the ones who are affected is desirable, even if that support has fiscal costs.

[18] 'Austerity… was the wrong target' according to Daniel Gross, the director of the Centre for European Policy Studies, a Brussels-based think tank. *What makes Greece special*, The Project Syndicate, March 6th 2014.

Second, product markets need to be competitive so that reductions in demand are reflected in lower prices. This helps the recovery of competitiveness and reduces the social cost of wage reductions. Product markets in Greece tend to be oligopolistic which is reflected in the fact that prices have hardly fallen despite the most severe recession in 70 years. While the main blame for the lack of reform lies with Greek policymakers, the importance of product markets was initially ignored by Greece's creditors who pressured for measures to reduce the budget deficit rather than to enhance competition.

Third, financing is a necessary input to the process of reallocating productive capacity towards the tradable sector. Domestic credit has been greatly reduced because Greek banks have been hit by recession, the haircut on public debt and a huge drop in deposits, driven by recurrent fears of a possible exit from the euro. While Greece's place in the euro now seems (relatively) secure and banks were recapitalized in the second half of 2013, credit is still very scarce and the Greek government does not have the resources or capacity to fix this problem. The unification of the European banking system would increase Greek banks' trustworthiness, thereby attracting back deposits and facilitating an increase in credit. However, the first steps towards banking unification have been very timid. Direct funding through the European Investment Bank has also been proposed but not implemented.

Finally, the reduction of Greece's (and the periphery's) external deficit would be facilitated if core countries followed expansionary policies, thereby increasing their imports from the periphery. However, core countries have followed restrictive fiscal policies (Figure 4.1) which has left their current account surpluses intact even as peripheral deficits decreased (Figure 3.2). Therefore, while the creation of external imbalances was symmetric across the Eurozone, the adjustment has occurred exclusively on the periphery, needlessly making the process more difficult. Olli Rehn, the European Commissioner for Economic and Monetary affairs, suggested several policies that Germany could follow (liberalizing services, investing in infrastructure and energy) which would both be beneficial to itself and facilitate peripheral adjustment. [19]

In conclusion, the elimination of Greece's "twin deficits" of the budget and the current account has occurred at enormous social cost and, in the case of the current account, it stands on shaky ground. The largest share of the blame, of course, belongs to Greek policymakers for allowing these imbalances to develop in the first place and for responding inadequately after the crisis started. At the same time, the European response has also been quite poor: the cause of the crisis was misidentified and the policy response was poorly targeted, at least during the first 3-4 years. None of this is to say that Greece could have avoided austerity as it is clearly infeasible for a country to run deficits of such a magnitude for any length of time. However, the crisis's roots lie in the imbalances of the external sector and European policymakers must now focus on how to facilitate the adjustment in that dimension.

[19] Olli Rehn, *Turning Germany's surplus into a win-win for the Eurozone*, http://blogs.ec.europa.eu/rehn/turning-germanys-surplus-into-a-win-win-for-the-eurozone/, also published in the Frankfurter Allgemeine Zeitung, November 11th 2013.

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